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# International Economic & Energy Weekly

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3 January 1986

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3 January 1986

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International  
Economic & Energy Weekly

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**International  
Economic & Energy Weekly**

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**Synopsis**

1	<b>Perspective—Debt-Troubled LDCs and the Challenge of Economic Reform</b>	25X1
	Prescriptions from international organizations and private creditors and their governments advocate extensive economic reform as part of the answer to restoring the financial viability of debt-troubled LDCs. While most debtor governments are beginning to realize that some fundamental economic policy changes are necessary, domestic political realities probably will inhibit effective implementation.	25X1
3	<b>Poor Brazilian Coffee Crop: A Blessing for Latin American Coffee Exporters</b>	25X1
	Brazil's current coffee crop—now experiencing an extended drought—could be half the past year's harvest. The international coffee market has reacted with a surge in coffee futures prices of more than 80 percent since September.	25X1
7	<b>Uruguay: Dim Prospects for Economic Recovery</b>	25X1
	Julio Sanguinetti, Uruguay's President since March, is counting on further liberalization of the basically free market economy to ease foreign debt difficulties as well as address popular demands for economic improvement. In our judgment, domestic pressure and weakening exports will endanger compliance with the IMF program and threaten the overall financial rescue package.	25X1
13	<b>Venture Capital: Heightened Foreign Interest</b>	25X1
	Foreign governments and industry, captured by the successful US example, are looking to venture capital to facilitate innovation. Despite government and industry efforts to promote venture capital, many barriers will continue to inhibit the development of robust markets abroad.	25X1
19	<b>French Fighter Exports: Limited Prospects</b>	25X1
	France continues to lose export customers for its jet fighter aircraft. Declining sales are likely to weaken the financial condition of France's military aircraft industry, increase procurement costs for the French air force, and probably reduce the number of fighters France can buy for its own forces.	25X1

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**International  
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**Perspective*****Debt-Troubled LDCs and the Challenge of Economic Reform***

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Prescriptions from international organizations and private creditors and their governments advocate extensive economic reform as part of the answer to restoring the financial viability of debt-troubled LDCs. In most of these countries, the reforms being encouraged would mean a drastic redirection of economic and development policies now in place, which are largely characterized by massive state intervention in trade, production, and pricing.

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The reforms being recommended would include:

- Dismantling significant tariff and nontariff barriers and export disincentives.
- Selling off large inefficient parastatals or state-owned companies, including those operating in industries considered key to the national interest, such as oil and minerals.
- Adopting realistic exchange rate policies to alleviate the chronic overvaluations of debtor currencies.

These reforms are intended, in turn, to restore financial viability by improving external balances, restoring economic growth, and inducing inflows of voluntary financing.

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We believe that governments would have to demonstrate a sustained commitment to structural reforms—for at least 12 to 18 months—before domestic and foreign businessmen would begin to invest or voluntarily lend. In the short run, however, we believe governments' commitments to economic reform are likely to waver, in part, because many of the suggested economic adjustments will cause temporary dislocations. For example, dismantling tariffs would reduce government revenues—in Argentina these taxes account for 20 percent of government receipts. Additionally, streamlining and/or privatizing public-sector firms is likely to temporarily increase unemployment, while currency devaluations will raise price levels. Many of these countries—such as Mexico and Argentina—have implemented adjustment programs in the past with great fanfare only to drift away from their commitments a few months later.

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In this environment of short-term costs and long-term benefits, we believe implementation and continued acceptance of market-oriented reforms will be difficult—especially in Latin America—because they run counter to the historical economic thought and deep-seated social and political values of the countries involved.

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According to many academic studies, a large segment of Latin society believes that a broad government role in the economy continues to be essential to ensuring that development reaches all levels of society. The Latin American political culture also regards the government as the protector of special interests such as labor and local business. In a climate of greater privatization and foreign presence, the power of these groups would be threatened.

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While most debtor governments are beginning to realize that some fundamental economic changes are necessary, domestic political realities probably will inhibit effective implementation. Many of these countries—especially the new Latin American democracies—are grappling with how to build a national consensus on economic development policy and how to maintain their democratic governments. They will, in particular, be looking for a quid pro quo—open markets, financing, and stimulative policies in the industrialized economies—for any Western-initiated policy changes they make.

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**Poor Brazilian Coffee Crop:  
A Blessing for Latin American  
Coffee Exporters**

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Brazil's current coffee crop—now experiencing an extended drought—could be half the past year's harvest. The international coffee market has reacted with a surge in coffee futures prices of 80 percent since September. Because of the price surge, the International Coffee Organization (ICO) quota release mechanism has placed 5 million bags on the market since October in an attempt to stabilize prices. With prices still trending upward, quotas are likely to be suspended entirely next month. As a result of these events, Latin American coffee export earnings in 1986 could jump by nearly 50 percent to about \$10 billion, with Colombia and Central American countries the biggest gainers. Even Brazil will gain by the increased price of its exports, which should more than offset possible volume reductions. If, however, the ICO fails to adequately temper the price increases and facilitate an orderly flow of coffee supplies, consuming country members of the ICO, including the United States, may withdraw from the organization. Although such a pullout currently would have little impact, the ability of the ICO to support minimum prices in the future would be undermined.

**Effects of the Drought**

An extended drought in Brazil's key producing states of Parana, Sao Paulo, and Minas Gerais—which produce almost three-fourths of Brazil's total production and almost all of its finest quality arabica coffee—is sending shock waves through the global coffee market. Trade analysts estimate that the effected crop, due to be harvested next April through August, could be as low as 15 million bags. This compares with the excellent 1985/86 marketing year crop of 33 million bags, which accounted for one-third of global production. While Brazil has sufficient physical supplies of coffee to meet its domestic consumption needs of 9 million bags and

its export commitments of almost 19 million bags, it appears unable to satisfy foreign demand for quality arabica coffee. As a result, prices have risen above \$2.40 per pound, an 80-percent increase since September.

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Supplies from other members of the ICO should partially offset the Brazilian shortage. In recent weeks, the ICO's composite price indicator—based on a basket of coffee types with varying quality and price differences—has exceeded the \$1.20 to 1.40 a-pound price range, which resulted in the release of 5 million bags in export quotas. If the price remains above \$1.50 per pound for 45 consecutive market days—as many analysts predict—quotas will be suspended altogether on 19 February.

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**Earnings Impact On  
Latin American Producers**

If prices remain high, Latin America coffee export earnings could jump by nearly 50 percent to about \$10 billion:

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- Colombia—the world's second-largest producer—could earn at least \$2.5 billion in 1986 from coffee exports, up almost one-half from estimated 1985 revenues. Bogota depends on coffee for over one-half of its total annual foreign exchange earnings and should be able to unload its costly stocks—currently the world's largest and equal to over one year's production.
- Even in Brazil the earnings benefit from the upsurge in prices is expected to be substantial and more than offset possible volume reductions. According to recent US Embassy reporting, coffee earnings could total a record \$3.4 billion this year, up 25 percent from estimated 1985 export revenues.

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**Secret****Latin America: Trends in Coffee Production, 1974-86<sup>a</sup>***Million 60 kg Bags*

Year <sup>a</sup>	Brazil	Colombia	Other Latin America	Total Latin America	Total World	Latin America as Percent of Total World
1974/75	27.5	9.0	18.6	55.1	82.8	66.3
1975/76	23.0	8.5	16.6	48.1	73.1	65.8
1976/77	9.3	9.3	16.1	34.7	60.9	57.0
1977/78	17.5	11.1	17.8	46.4	70.9	65.4
1978/79	20.0	12.6	19.7	52.3	78.9	66.3
1979/80	22.0	12.7	19.6	54.3	81.9	66.3
1980/81	21.5	13.5	20.1	55.1	86.3	63.8
1981/82	33.0	14.3	19.7	67.0	98.1	68.3
1982/83	17.8	13.3	21.9	53.0	83.3	63.6
1983/84	30.0	13.0	20.0	63.0	90.4	69.7
1984/85	27.0	11.0	20.8	58.8	90.4	65.0
1985/86 <sup>b</sup>	33.0	12.5	20.6	66.1	98.6	67.0

<sup>a</sup> International coffee marketing year October-September.<sup>b</sup> USDA forecast.

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**Latin America: Value of Coffee Exports, 1975-86***Billion US \$*

Year	Brazil <sup>a</sup>	Colombia	Central America	Other <sup>b</sup>	Total
1975	0.94	0.68	0.57	0.40	2.59
1976	2.40	0.98	1.01	0.83	5.22
1977	2.63	1.53	1.83	1.11	7.10
1978	2.30	1.99	1.79	1.04	7.12
1979	2.33	2.02	1.79	1.32	7.46
1980	2.77	2.38	1.71	0.91	7.77
1981	1.76	1.46	1.31	0.73	5.26
1982	2.13	1.58	1.28	0.79	5.78
1983	2.32	1.54	1.29	0.98	6.13
1984	2.85	1.80	1.33	0.97	6.95
1985	2.70	1.70	1.35	1.00	6.75
1986 <sup>c</sup>	3.40	2.50	2.30	1.70	9.90

<sup>a</sup> Includes soluble and roasted coffee exports for Brazil only.<sup>b</sup> Mexico, Dominican Republic, Haiti, Jamaica, Trinidad and Tobago, Bolivia, Ecuador, Paraguay, Peru, and Venezuela.<sup>c</sup> Estimated.

The other major gainers from the upturn in prices and likely suspension of ICO export quotas would be El Salvador, Guatemala, Costa Rica, and Honduras. Until the price boom, these countries invariably were forced to market their nonquota surplus production to nonmembers of the ICO at discount prices. All of these countries produce good quality arabica coffees and their economies depend on coffee for one-fourth or more of their total annual export earnings. Earnings for Central America could total \$2.3 billion in 1986, as compared with an annual average of \$1.3 billion for 1982-84.

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**International Coffee Agreement (ICA) Being Tested**

The sharp rise in coffee prices also will put the price stabilization mechanisms of the ICA to the

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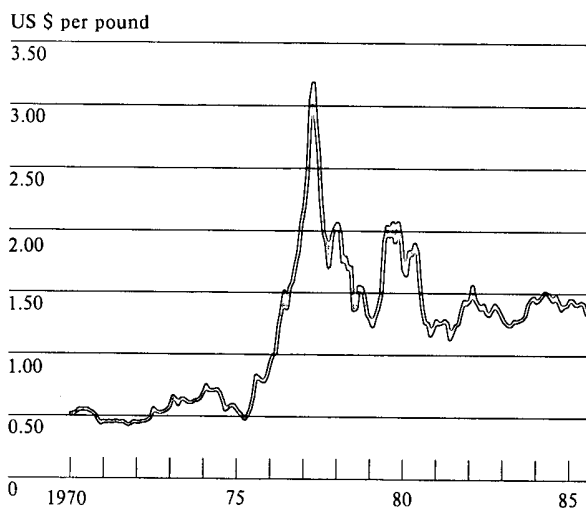
**Importance of Coffee Trade to Latin America**

*Despite export diversification, coffee continues to be the most important agricultural export item and represents the economic backbone of many Latin American countries. For 1980-82, coffee represented one-fifth or more of total export earnings in El Salvador (60 percent), Colombia (54 percent), Nicaragua (35 percent), Haiti (26 percent), Guatemala (26 percent), Honduras (24 percent), and Costa Rica (24 percent). The largest traditional single market for this coffee—and the world's single largest coffee consumer—is the United States. Annually the United States imports over one-half of the region's total exports and for some countries the United States accounts for over two-thirds of their global coffee sales.*

*The coffee industry also typically acts as a catalyst for domestic economic activity with the creation of significant levels of direct and indirect employment and generation of vital tax revenues. The coffee sector in Colombia, for example, accounts for 6 to 7 percent of its GDP and directly employs about 10 percent of the population. The debt crisis in many of these countries, coupled with weak prices for sugar and key mineral exports, has only heightened the need for coffee revenues for servicing debt obligations.*

test. While the pact has a reputation for being fairly successful in defending floor prices, it remains to be seen if the pact can stem the increase in prices for the sake of consumer member nations. After the Brazilian freeze of 1975, coffee prices rose from under \$1 a pound to over \$3 a pound.

The ICO is also being challenged over the issues of quota flexibility, quota undershipments, and discount pricing to nonmembers of the agreement. During the last two years, some exporting members

**Trends in Coffee Prices, 1970-85<sup>a</sup>**

<sup>a</sup> Average monthly coffee price for other mild arabicas—a type of coffee exported by Mexico and Central American countries.

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of the ICO fell substantially short of filling 25 percent of their export quotas during each of the first and second quarters of the quota years as required by provisions of the ICO. Although these countries have always met their quotas by the end of the year, these quota undershipments during the first half of the year deprived consumers of an orderly flow of coffee and contributed to price instability. Undershipments were particularly troublesome because they occurred while some exporting members were shipping to nonmembers of the ICO at substantially reduced prices.

Given these issues, attention is now being focused on whether the recent increases in quotas will be met or whether producers will withhold coffee in

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could further undermine the agreement in the eyes of consumer nations. This comes at a time when Washington is reviewing its participation in the coffee agreement and must decide whether to ask Congress to extend enabling legislation beyond September 1986. [REDACTED]

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**Longer Term Outlook**

While the market is experiencing considerable strength in futures prices, the recent price surge would be mild to what could occur if Brazil's next coffee crop were to experience frost damage during the upcoming winter season (June-August). Such damage could send prices skyrocketing, especially in light of expected drawdowns in stocks to meet the current shortfall. If, on the other hand, Brazil passes through the frost season unscathed and other major producers have good crops entering the market next year, prices could return to more normal levels of under \$1.40 a pound. [REDACTED]

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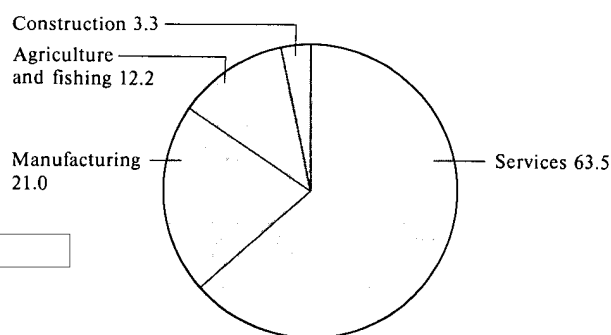
## Uruguay: Dim Prospects for Economic Recovery

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Julio Maria Sanguinetti, Uruguay's President since March, is counting on further liberalization of the basically free market economy to ease foreign debt difficulties as well as address popular demands for economic improvement. Progress in this area has enabled Montevideo to reach agreement with the IMF and its commercial creditors, but a domestic economic turnaround has not yet materialized. We believe that after five straight years of economic decline, labor, business, the opposition, and the military will demand that Sanguinetti reconsider the free market program in 1986. In our judgment, this domestic pressure and weakening exports will endanger compliance with the IMF program and threaten the overall financial rescue package.

### Uruguay: Real GDP by Sector, 1984

Percent



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### Sanguinetti's Inheritance

Uruguay is heavily dependent on commodity exports and its public sector as engines of growth. The economic expansion of the 1970s has been blunted since 1981 by world recession, weak domestic demand, and deteriorating economic conditions in Brazil and Argentina, which purchase 20 percent of Uruguayan exports and are major sources of foreign capital. Simultaneously, inflation has been driven up by the Central Bank's need to print money to cover a yawning public-sector deficit. Between 1981 and 1984:

- GDP fell about 16 percent, with the manufacturing and construction sectors registering the largest declines.
- Unemployment increased to 14 percent, causing growing emigration of young, educated workers, according to the US Embassy.
- Inflation tripled, causing a 30-percent drop in real wages.

Persistent current account deficits have forced sharp cuts in imports. Falling world prices for wool,

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beef, and textiles, however, have led to a declining trade surplus while interest payments were rising. A substantial loss of official foreign reserves resulted, according to the US Embassy, as foreign creditors suspended new financial support when the IMF discontinued disbursements on Uruguay's standby in December 1983.

Montevideo tried without success to negotiate a new IMF agreement in 1984, and commercial banks confined their financial assistance to rollover of maturing debt.

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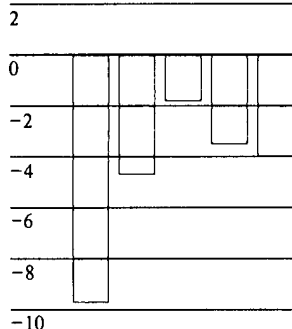
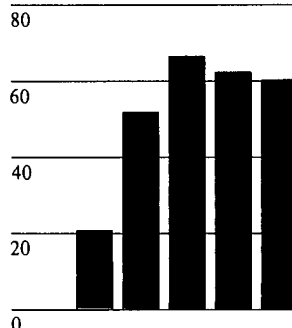
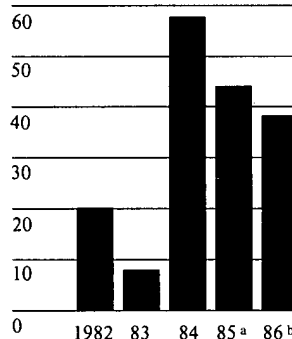
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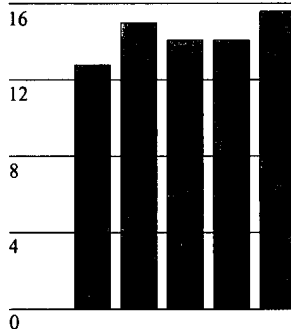
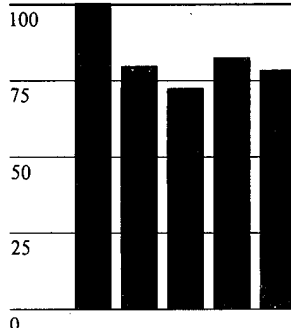
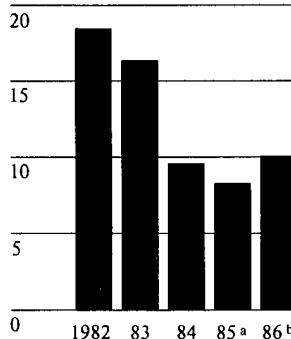
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**Secret****Uruguay: Selected Economic Indicators, 1982-86**

Note scale change

**Real GDP Growth**  
Percent**Consumer Price Growth**  
Percent**Monetary Expansion**  
Percent

<sup>a</sup> Estimated.  
<sup>b</sup> Projected.

**Unemployment Rate**  
Percent**Real Wages**  
Index: 1982=100**Public Sector Deficit**  
Percent of GDP**The New Government's Policies**

Sanguinetti's economic ministers favor a market-oriented approach to fueling domestic economic recovery and improving the external accounts. The US Embassy reports that Economy and Finance Minister Zerbino, domestic economic policy czar, supports competitive exchange rates to stimulate export-led growth and cuts in government spending and improved tax collection to reduce inflation. Uruguay's economic leadership also believes that paying the external debt is integral to its recovery program and to regaining access to new development credit. According to press reports, Minister of Foreign Affairs Iglesias, the secretary pro tem of the Cartagena Group of Latin American debtors has publicly called for political solutions to ease the repayment burden but does not advocate a debtors' cartel or debt repudiation. [ ]

Montevideo has moved quickly to shore up its precarious payments position. Since April, Zerbino has sought to conclude negotiations with the IMF and creditor banks for a multiyear rescheduling of the external debt and \$270 million in new funds. The financial assistance package signed at the end of September includes \$120 million in IMF funds over 18 months as well as \$150 million in new loans. Creditors also granted a graduated repayment schedule with lower interest rates and a three-year grace period. In turn, Montevideo promised the Fund that it would reduce its inflation rate to a 45-percent annual rate for 1986, maintain a floating exchange rate to improve exports, and reduce the fiscal deficit to 5 percent of GDP by December 1986. [ ] the program aims to boost GDP growth to 2 to 4 percent next year. [ ]

The export sector has received the greatest initial attention. According to the US Embassy, peso depreciation has kept pace with domestic inflation, stabilizing export competitiveness. Exporters also benefit from reimbursement of indirect taxes, duty-free import of components and raw materials for reexport, and subsidized export credits. A new trade agreement with Buenos Aires allows for

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increased exports of selected agricultural and industrial goods and for expanded Argentine technical assistance in improving oilseed production. Brazil has agreed to increase imports of Uruguayan agricultural products and cemented the deal with a purchase of 20,000 metric tons of beef. [redacted]

Similarly, Montevideo is also reshaping domestic spending priorities to balance creditor requirements against popular concerns. According to press reports, Sanguinetti is moving to reduce the budget deficit by holding the central government's overall expenditures constant, increasing revenues from the value-added tax, and implementing strict new tax collection procedures. State enterprises are to reduce personnel and streamline their operations, [redacted]

[redacted] To bolster living standards, the government will rechannel funds into social programs at the expense of the defense budget, while additional social service spending will be funded by higher taxes. For example, the Senate recently approved new inheritance, excise, and customs taxes, the proceeds from which will be allotted to fund new education and health programs. [redacted]

### Economic Recovery Languishes

[redacted] the economy registered a 3-percent drop in GDP in the first nine months of 1985—a much more pessimistic figure than that given the IMF. Although real wages have risen 12.5 percent, improved public finances enabled the Central Bank to reduce the rate of monetary expansion, making credit scarce and expensive. Additionally, recovery is being restrained by weak consumer demand, lack of industrial investments, falling exports, and, according to the financial press, depressed construction activity. Although good weather will probably

spur 4-percent growth in agricultural production, we believe that Uruguay's economy will contract for the sixth consecutive year. Consequently, we believe that unemployment will end the year at about 14 percent while we predict only a slight decline in inflation from the 1984 level. [redacted]

In addition, according to the US Embassy, Uruguay is still battling external cash strains. As of October, exports from Uruguay were down 13 percent from last year's level of \$925 million, [redacted]

[redacted] we believe 1985 imports were down 11 percent, but the trade surplus still fell short of the \$369 million in interest payments. [redacted]

Against his initial bold promises to get the economy moving, Sanguinetti's lackluster record is weakening his popularity. US Embassy reporting indicates that the share of the populace rating Sanguinetti's performance as good or very good dropped from 60 percent in June to 39 percent in July. According to a Gallup poll in October, 56 percent of Uruguayans indicated dissatisfaction with the government's efforts to confront the economic crisis. [redacted]

### Rough Sledding Ahead

With tough debt negotiations behind him and labor disputes easing, Sanguinetti has an opportunity to revive the economy. Continuation of his cautious approach, potential benefits from the new trade agreements, and the passage of legislation to ease

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## Uruguay: Current Account Trends, 1982-86

Million US \$

	1982	1983	1984	1985 <sup>a</sup>	1986 <sup>b</sup>
<b>Current account balance</b>	<b>-426</b>	<b>-189</b>	<b>-124</b>	<b>-172</b>	<b>-160</b>
Trade balance	-64	257	166	131	130
Exports	1,023	1,045	925	805	780
Imports	1,087	788	758	674	650
Net services	-363	-447	-291	-303	-290
Of which:					
Net interest	-188	-288	-362	-369	-375
Debt service ratio <sup>c</sup> (percent)	18	28	39	46	48
Net external debt	3,102	3,481	3,671	3,400	3,800

<sup>a</sup> Projected.<sup>b</sup> Estimated.<sup>c</sup> The ratio of interest payments to export earnings.

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industry's debt situation could result in a return to modest economic growth. We doubt, however, that Montevideo will be able to keep the social consensus needed to engineer a recovery, and as a result we believe that Uruguay's economy will continue to decline. Traditionally, labor remains quiet through April as workers enjoy summer vacations, but the lack of an economic turnaround will probably spark the return by midyear of disruptive strike activity and calls to suspend debt repayments. Sanguinetti's political opponents will probably also try to gain ground by calling for growth-oriented policies, while military officials will probably lobby for increased defense spending. We expect private businessmen to continue to demand an easing of their huge debt burdens, which were brought on by falling demand and lack of investment. In addition, as businesses fail, the Central Bank will face demands for financial bailouts, which would enlarge the fiscal deficit and threaten the achievement of IMF targets. [redacted]

Under such conditions, there is a serious risk that Uruguay's foreign financial rescue program could

unravel this year. [redacted]

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exports will probably decline again, as falling world prices bite into commodity export earnings and developed countries limit their purchases of textile products. Consequently, we expect that Montevideo will again fall out of compliance with its Fund program and that commercial bank creditors will remain unwilling to disburse funds already committed. The ensuing payments squeeze will probably threaten Montevideo's ability to meet regular interest payments and its ability to import. [redacted]

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**Implications for the United States**

We believe that economic uncertainties in Montevideo will create friction in commercial relations with the United States. Driven by the need to export, Uruguayan complaints of protectionism are likely to intensify. Poor economic performance will provide ample grounds for labor to intensify its attack

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***Labor's New Militant Role***

*Frustrated by 10 years of falling real wages and growing unemployment, Uruguayan labor has grown militant in the country's freer political climate. Workers have taken advantage of their newly won rights to organize and strike by forming 223 new unions and staging over 200 strikes and work stoppages since Sanguinetti took office last March. These work stoppages, in turn, have disrupted normal commercial activity, contributing to the large drop in Uruguay's exports. In addition, labor's ability to obtain real wage increases has worked at cross purposes with government efforts to reduce inflation.* [redacted]

*Union leaders, largely left leaning, also take an antagonistic view of the government's economic strategy, and some unions have called on Sanguinetti to bypass the IMF and repudiate the foreign debt. According to the US Embassy, however, civilian politicians are losing patience with labor. The government has tried to engineer a social pact with labor, but also showed a strong hand in ending the six-week strike of national railroad workers last September. When union leaders refused to accept management's salary proposal, the government broke off wage talks, and, in a climate of weak public support for the strike, forced a return to work.* [redacted]

*Although this tougher approach has caused labor to become relatively quiet since September, we believe that workers will again begin to voice demands for greater benefits and a larger role in public policy making. Given labor's strong link to the opposition, work disruptions and political protests could again erupt this year, impeding economic stabilization and testing military support for democratic government.* [redacted]

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on Sanguinetti's debt policy and probably will renew appeals to Washington for short-term financial assistance. A perception that the United States was unresponsive and unsympathetic to Uruguay's plight would encourage Sanguinetti to support a more confrontational posture by the Cartagena Group. Should Montevideo declare a payments standstill it would likely impose tighter exchange controls and new import barriers. [redacted]

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## Venture Capital: Heightened Foreign Interest

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Foreign governments and industry, captured by the successful US example, are looking to venture capital to facilitate innovation. Although such markets—particularly in the United Kingdom, the Netherlands, and Japan—have expanded rapidly in the past few years, they remain relatively small and dominated by conservative financial institutions. Despite government and industry efforts to promote venture capital, many barriers will continue to inhibit the development of robust markets abroad. Foreign firms are investing substantial amounts in the active US venture capital market to gain access to new technological developments because of limited domestic opportunities. Nonetheless, we believe that the close relationship between industry and financial institutions in Japan and Western Europe may serve as an effective alternative for funding risky ventures.

### Foreign Venture Capital Markets

A variety of Japanese and West European government and industry studies pinpoint ready access to venture capital as a significant US competitive advantage. These studies indicate that the large and active US venture capital market—by providing significant amounts of funds to innovative, high-technology startup companies—has encouraged major technological advances. The realization that venture capital can promote commercialization of new technologies has convinced Japanese and European leaders that a strong venture capital market will add to the competitiveness of high technology as well as traditional industries.

Venture capital investments in Japan and Western Europe, virtually nonexistent until the early 1980s, have grown rapidly:

- In Japan, there are 62 venture capital firms, over three times the number that existed in 1982. Only 22 percent of Japan's startups, however, receive funds from venture capitalists.

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### Defining Venture Capital

*Despite its general usage, the term venture capital can have several distinct meanings. In a broad sense, it refers to capital available for high-risk investment opportunities with high earnings potential. This definition covers all high-risk, high-potential investments, regardless of the origin of the funds, the way they are allocated, or used. Funds allocated by an investment pool for the purchase of oil exploration blocks, for instance, come within this definition of venture capital. In a narrower sense, it refers to capital committed, as equity, for the formation and setting up of small firms specializing in new ideas or new technologies. However, venture capital companies also look for significant amounts of loan capital. Furthermore, venture capitalism is not solely the injection of funds into a new firm. It also includes the input of the skills necessary to organize and manage the firm.*

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- UK venture capital firms have provided over 60 percent of the European total.
- Italy and France have small venture capital markets, with investments of about \$100 million each.

Much of these funds, however, are currently being channeled to US ventures. Indeed, nearly 20 percent (\$3 billion) of US venture capital comes from foreign sources.

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The sources of venture capital in Japan and Western Europe are similar, but both differ significantly from sources in the United States. The majority of Japanese venture capital—primarily in the form of

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**Secret****Venture Capital: Relative Market Sizes**

	Million US \$		Number of Professional Venture Capital Firms	
	1982	1984	1982	1984
United Kingdom	500 <sup>a</sup>	2,629	36	99
Netherlands	110 <sup>a</sup>	526	NA	33 <sup>b</sup>
Japan	86	440	18	62
West Germany	120 <sup>a</sup>	225	NA	30
Italy	NA	122	NA	7
France	NA	114	16	30
United States	7,600	16,300	350	500

<sup>a</sup> Estimated.<sup>b</sup> Includes only officially recognized venture capital firms.

debt—originates from the large city banks, securities companies, and, to a lesser extent, insurance and trading companies. In Europe, banks and corporate investors also make up the primary sources, generally providing loans rather than equity capital. In contrast, US venture capital comes mainly from pension funds—more than one-third of the total—with foreign and private investors, along with corporations, providing smaller, but roughly equal, amounts.

Because conservative financial institutions dominate foreign venture capital markets, the actual level of funds channeled to high-risk ventures is limited. Only about 10 percent of Japanese and 20 percent of European venture capital actually goes to firms just starting up, as compared with about 40 percent in the United States. While US investors accept high risk as a trade-off for potentially large capital gains when a startup company goes public, Japanese and European venture capitalists are more interested in providing limited funds to established firms likely to become future borrowers or to provide capital gains more quickly. In Japan, for example, the volume of loans from venture capital firms to businesses outweighs similar equity

investments by more than 4 to 1. Similarly, foreign securities firms provide funds to ventures that are close to public listing to gain the underwriting business. Foreign investment in US ventures, however, is more extensive because of the desire to acquire US technologies.

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**Continuing Barriers to Growth**

Several factors continue to inhibit the development of active markets abroad:

- Underdeveloped stock exchanges and the lack of secondary markets are particularly constraining. Because most investors expect to obtain their return by selling their investment shares to earn a capital gain, the availability of an active stock exchange is a necessity. Moreover, secondary markets such as NASDAQ in the United States are needed to provide markets with less stringent listing requirements for the small high-risk firms. As long as banks dominate corporate financing in Japan and Europe, chances of developing full-fledged equity markets quickly are limited.
- A lack of experienced management reduces the attractiveness of new ventures. A recent Japanese survey found 90 percent of venture businesses felt a lack of skilled management was a major problem. In addition, Japanese antimonopoly laws prohibit venture capitalists from actively participating in firms they invest in, further limiting a company's access to skilled management.
- A weaker tradition of entrepreneurship results in low demand for venture capital. Because Japanese and Europeans prefer the security of lifetime employment with an established company, significantly fewer startup companies appear. Moreover, aversion to high-risk investments continues to permeate Japanese and European culture with strong social biases against persons associated with failed businesses—the inevitable fate of many startup firms.

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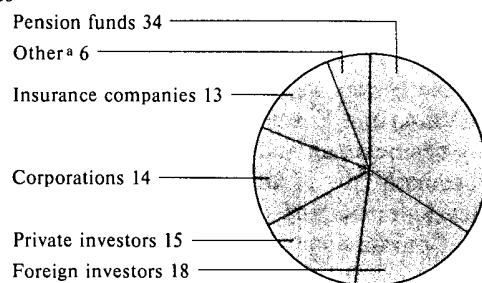
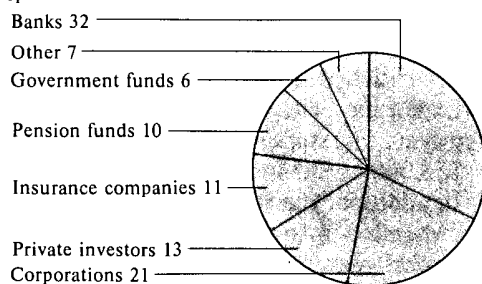
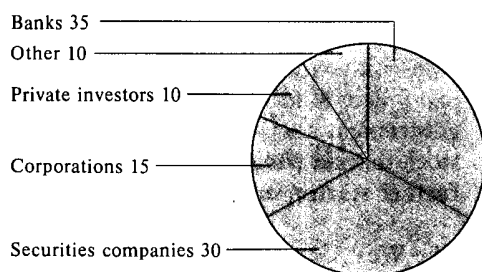
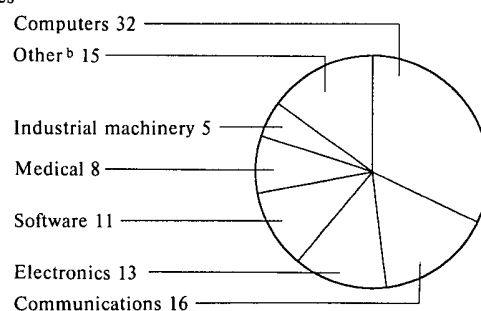
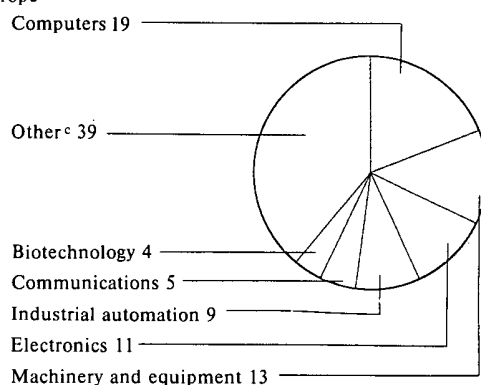
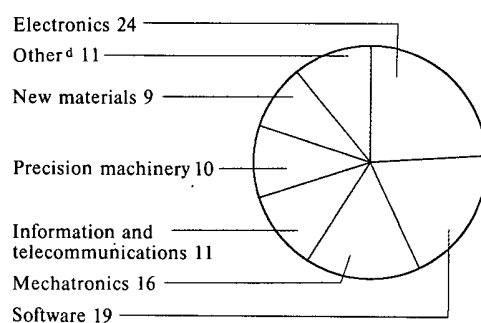
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**Venture Capital: Sources and Uses, 1984**

Percent

**Sources of Funds****United States****Western Europe****Japan**<sup>a</sup> Including endowments and foundations.<sup>b</sup> Including genetics, energy, and retailing.<sup>c</sup> Including chemicals, agriculture, and retailing.<sup>d</sup> Including biotechnology, energy, and marketing.**Uses of Funds****United States****Western Europe****Japan**

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In addition, US tax laws provide better opportunities to shelter income through high-risk ventures. For example, the provisions for writing off capital gains have, until recently, been more generous than in Western Europe and Japan. The United States also has special legislation to encourage investment in particular sectors, such as synfuels in the 1970s.

### Promotional Policies

In an effort to overcome these obstacles and channel funds into high-risk companies, foreign governments and industries are actively promoting policies to expand the use of venture capital. These measures, usually patterned after practices in the United States, are aimed primarily at reducing the capital gains tax and at promoting the development of secondary stock markets. Japanese Government promotion efforts include:

- Relaxing the criteria for listing companies on the over-the-counter stock exchange in 1983 to facilitate venture businesses going public.
- Establishing the Venture Enterprise Center (VEC) that helps businesses strengthen their R&D efforts by guaranteeing 80 percent of loans up to 100 million yen, currently about \$500,000.
- Providing loans through MITI and the Japan Development Bank (JDB) at below market financing with long-term repayment periods for new projects. The JDB's charter was recently amended to allow it greater involvement in the venture capital arena by increasing the level of low-cost funding available to high-tech companies.
- Current legislation submitted by MITI called the Venture Business Promotion Law, which includes tax-free reserves for R&D and for investment losses if a venture fails.

In addition, many local governments and prefectures are offering various incentives, such as low property taxes and preferential loans for venture businesses because of their employment and revenue potential.

A number of limited actions have been taken by the European Community (EC) to spur the region's use of venture capital. Last March, for example, the European Commission announced the availability of \$800,000 for venture capital investments in small- and medium-sized businesses. The European Commission has also established Euromtech, a public/private venture capital fund, which will provide about \$14 million for venture projects in the EC. In addition, privately funded groups, such as the European Venture Capital Association (EVCA) and Euroventures, have been established by businessmen and venture capital firms to ensure a smooth flow of information on venture capital developments and to provide advice to the European Commission on ways to expand its use.

Individual European countries are also implementing measures to encourage the use of venture capital:

- The United Kingdom established the Unlisted Securities Market in 1980. In 1983, the Business Expansion Scheme was introduced that offers private investors special tax incentives up to \$53,000 a year for investments in new companies. In addition, the Bank of England has partial ownership in Investors in Industry—Britain's largest venture capital firm—which provides a direct channel for government funds for industry.
- The Dutch Government guarantees up to 50 percent of the losses incurred on individual investments by recognized venture capital firms and established a government-backed equity fund, MIP, in 1982, to offer equity to firms involved in high-risk ventures. The MIP now provides nearly one-fourth of all Dutch venture capital. The government also has established a secondary stock market similar to that in Britain to provide further startup incentives.
- The West German Senat Innovation Fund, established in 1982, has provided about \$10 million to startup firms. In addition, a subsidy program worth about \$25 million began funding technology ventures this year. In 1986 West German venture capital firms will also get special tax

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breaks if they raise money on German stock exchanges and invest it in at least 10 firms. Due to local incentives, about half of West Germany's venture funds are invested in Berlin.

- France has provided special tax incentives to investors, including a lower capital gains rate for individual investors and the creation of a secondary market with flexible listing requirements for new firms. In addition, the Industrial Development Institute has provided nearly \$4 million for venture capital promotion, and the Directorate of Telecommunications has established a \$2.5 million joint venture with Sofinnova—a state-owned venture capital firm—to provide equity capital to small firms in the telecommunications sector.

giving the French concern access to a wide range of emerging electronics technologies.

- A United Kingdom electronics firm, Thorn EMI, has allocated \$5 million for venture capital investment in the United States to acquire computer and computer-related technology.
- Olivetti, the Italian electronics giant, has invested about \$60 million in nearly 30 US venture businesses. Besides gaining access to US technology, it hopes to use these US firms as outlets for its products.
- Kyocera of Japan has established a venture capital firm in the United States

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Japanese and West European—especially West German—firms have also established their own venture capital subsidiaries to allow small pools of personnel to resign and establish spinoff firms to commercialize products which do not fit into current corporate activities. A group of Siemens personnel, for example, recently established ICT, a semiconductor testing company. In return for financing, ICT will give Siemens access to its technology developments.

### Outlook

Major barriers, such as national tax and financial systems, will continue to inhibit the development of venture capital markets in Japan and Western Europe.<sup>1</sup> Corporate reliance on large banks for finance and the aversion of European and Japanese investors to high risk will also continue to limit the development of true venture markets. Although the recent liberalization of Japanese financial markets has alleviated some entry restrictions, changes remain slow and cumbersome. In addition, unless the EC can unify many of its financial and regulatory practices, the development of venture capital on the continent will be slow during the next decade.

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### Targeting US Technology

Foreign corporations are using venture capital as a method to acquire US technologies—targeting areas such as computers, software, and biotechnology. Because foreign companies often lack the analytic skills in assessing venture opportunities, they usually use US venture capital firms as middlemen. Japanese trading companies are increasingly forming syndicates to raise domestic venture capital funds for investment in the United States.

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Despite foreign perceptions, we believe the extent of the US competitive advantage from venture capital may be offset by other factors. US industry executives and analysts point to the ability of the financial systems in Japan, France, and West Germany to provide low-cost funds to domestic companies and to their firms' ability to carry high debt

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Examples of recent technology acquisitions include:

- A \$100 million venture capital partnership between CIT-Alcatel and a US firm in late 1984,

<sup>1</sup> We believe the UK venture capital market, however, will continue to deepen because of its developed financial markets and greater investor willingness to invest in risky ventures.

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levels. As a result, the risk of financing long-term R&D projects is greatly reduced. Moreover, government R&D programs in Japan and Western Europe provide significant financial and technical support to developing new technologies.

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### French Fighter Exports: Limited Prospects

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France continues to lose export customers for its jet fighter aircraft. Many former French clients are buying US planes, and, we believe, a variety of political, economic, and military factors will further reduce France's share of the non-Communist fighter market in the 1990s by more than half. Declining sales are likely to weaken the financial condition of France's military aircraft industry, increase procurement costs for the French Air Force, and probably reduce the number of fighters France can buy for its own forces.

have a reputation for being less sophisticated. The Mirage-2000, for example, suffered development problems, and early versions received an inferior engine that degraded the plane's speed and maneuverability. In addition, the Mirage-2000 has not yet been used in combat.

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### Losing Ground to the United States

France has long been dependent on foreign sales of jet combat aircraft to make its own purchases affordable and to ensure the financial viability of Avions Marcel Dassault, a major component of its aerospace industry. French sales represented about 7 percent of the non-Communist fighter export market during 1974-83; the United States held about 34 percent of the market. With a 2-to-1 margin over domestic sales, exports have reduced per-plane costs and helped France to recoup its development costs, thus enabling France to remain the only European state independently designing and producing high-performance fighters. Dassault, the manufacturer of Mirages, depends on military contracts for 90 percent of its revenues, and on exports for about 70 percent of its income,  Moreover, the sale of aircraft has created a large market for the sale of associated equipment, such as radars, missiles, munitions, and ground support equipment by other French firms. We estimate that aircraft and aircraft-associated sales have accounted for at least one-third of the roughly \$35 billion in France's arms exports over the last 10 years.

Since the late 1970s, French fighter aircraft exports have steadily lost ground to US fighters, particularly the F-16 and the F-18. French fighters

### Losing the Replacement Market

Because of their advancing age, most of the Mirage-III/5/50s will need replacement by the mid-1990s as they approach the end of their 20- to 25-year service life. France is working hard to win these replacement sales: its Rafale fighter, scheduled for introduction in the mid-1990s, is being designed as a lightweight, relatively less sophisticated ground attack plane, aimed particularly at Third World customers. About 300 Rafales will be produced for the French Air Force.

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Despite these efforts, many customers have already begun to replace their older Mirages with US planes: Australia has bought F-18s and Belgium

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**Secret****France: Sales of Mirage Aircraft, 1958-85<sup>a</sup>**

	III/5/50	F-1	2000
<b>Total</b>	<b>956</b>	<b>477</b>	<b>169</b>
Argentina	18		
Australia	116		
Belgium	106		
Brazil	21		
Chile	16		
Colombia	18		
Ecuador		18	
Egypt	88		40
Gabon	18		
Greece		40	40
India			40
Iraq		89	
Israel	121		
Jordan		35	
Kuwait		60	
Lebanon	12		
Libya	110	38	
Morocco		63	
Pakistan	96		
Peru			13
Qatar		14	
South Africa	55	48	
Spain	30	72	
Switzerland	55		
UAE	44		36
Venezuela	16		
Zaire	16		

<sup>a</sup> Since the mid-1970s the United States has exported 1,077 F-16s and 285 F-18s to 17 countries.

has purchased F-16s, for example. France has also lost—and we believe will continue to lose—a number of other large customers:

- Paris has denied itself several potentially lucrative markets. For example, France no longer sells aircraft to Israel and will not sell aircraft to

Libya while Libyan forces are in Chad. Paris also observes the UN embargo on arms sales to South Africa.

- Several Third World customers probably cannot afford new planes because of tight defense budgets and large foreign debt burdens. Argentina, which lost a number of Mirages in the Falklands war, and Zaire are two customers that we believe will find it nearly impossible to purchase any new aircraft. Peru has already announced a cut in its Mirage-2000 order from 26 to 13, and press reports indicate that France's reluctance to accommodate Saudi Arabia's wish to pay with oil instead of cash contributed to Riyadh's decision to buy Tornados from the United Kingdom instead of 40 to 45 Mirage-2000s.

- Some air forces—the Swiss Air Force, for example—are upgrading, rather than replacing, their older Mirages. Switzerland probably will not purchase new aircraft until the mid-1990s, and then only after a long, open competition.

delaying their purchase of replacement aircraft.

- Other customers have become involved in aircraft production programs of their own. Spain has joined the European Fighter Aircraft (EFA) group. Production of EFA—scheduled to begin in the early 1990s—combined with Spain's F-18 purchase will satisfy Madrid's aircraft needs into the next century.

- The increasing availability of Third World-oriented attack aircraft has cut into the Mirage markets. Customers may choose from the Brazilian-Italian AMX, the British Hawk, or the Spanish CASA-101. These aircraft provide cheaper alternatives to high-performance aircraft, such as the Rafale, and are able to fill many of the same roles.

Altogether, we estimate that France has already lost 741 Mirage replacement sales.

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**A Mixed Outlook**

France's reduced market share will still leave it as Western Europe's dominant exporter of fighter aircraft in the 1990s. France's aggressive marketing and offers of offset purchases and liberal financing can be expected to bring some new contracts. We believe that France will also continue to supply advanced aircraft to customers such as Egypt, Greece, and India that are also seeking to diversify their arms sources.

[redacted] to prod the USSR into selling MIG-29s on favorable terms. When Moscow agreed, New Delhi dropped its option to build another 110 Mirages.

Political considerations and diversification policies in the Third World may enable France to sell almost 100 more Mirage-2000s within the next 18 months. For example:

- Morocco may buy 30 to 40 Mirages if the United States does not approve the F-16 sale, [redacted]
- [redacted] Algeria is interested in buying 20 strike versions with an option for 20 more.

While projections of the world fighter market in 1995-2000 are inherently uncertain, the Rafale is likely to garner the vast majority of West European fighter exports. Its main competitor, EFA, will be larger, more expensive, and geared to air combat in Europe rather than for Third World conditions. Rafale will also be competitive among the Mirage clients that have not switched entirely to US

planes, such as Pakistan, and some major US customers of the past, such as Saudi Arabia, Jordan, and possibly Iran. [redacted]

**Implications for the French Defense Industry**

Declining French fighter exports will place new strains on the French defense industry and French military capabilities. Without large exports, the profitability of the French fighter industry and Dassault will be threatened. France may also face the politically unappealing need to cut aerospace jobs. In addition, the unit price of Dassault's products probably will rise dramatically—we estimate that each Mirage-2000 already costs \$25 million, and Rafale has a current estimated price tag of at least \$30 million. We believe increased unit costs probably will force a reduction in French Air Force procurements. Embassy reporting indicates that France may already be considering an early end to Mirage-2000 production to save money to invest in the Rafale and, possibly, to avoid cutting into Rafale's exports. A cutback in the Mirage-2000 would reduce the strength and effectiveness of the French Air Force in a European conflict, at least until the Rafale enters service in 1995. New Rafales will make up only part of France's lost capabilities, however, because they are not primarily designed for European combat.

France may also be forced to rethink its dedication to independent fighter procurement and participate in the effort to reduce Europe's defense costs through defense industrial cooperation. This process may already be beginning: in November 1985, France rejoined the EFA consortium and offered to accept a largely symbolic 5- to 10-percent share of the project's work. We believe the French decision was motivated, at least in part, by a desire to retain access to European aerospace markets and to gain a share of EFA's future export revenues. Beyond the year 2000, with France's own costs rising and

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exports dropping, Paris may be forced to become a full partner with Britain, Germany, and the other NATO members in multinational fighter projects.



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**Briefs****Energy*****Progress on Second  
Iraqi-Saudi Pipeline***

Riyadh has evidently approved installation of the most difficult portions of the 800-km second phase of Iraq's oil export pipeline through Saudi Arabia. The project will be delayed if the sections are not started soon. Work has already begun in Iraq on a new pumping station for the line.

[redacted] tenders for construction of the remaining Saudi portions are not expected before this spring. Completion of the second-phase pipeline and new loading facilities on the Red Sea coast of Saudi Arabia will probably take at least two years after the contract is tendered and will raise Iraq's oil export capacity by about 1 million b/d. [redacted]

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***Iraq Seeks Western  
Oil Assistance***

[redacted] Baghdad has invited US and UK oil companies to bid on oil exploration contracts for tracts in northwestern Iraq. Major Western oil firms have been limited to providing technical support since Baghdad completed nationalization of its oil industry in 1975. Iraq is interested in obtaining Western expertise and financing, and may hope that involving Western oil companies will help secure buyers for its crude. [redacted]

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***Japan Passes Product  
Import Legislation***

The first imports of gasoline—under recently approved import legislation—are scheduled to arrive in Tokyo this month. The bill to liberalize the imports of gasoline, kerosene, and gas oil was passed on 13 December. The first deliveries

[redacted] will be shipped from Canada, Saudi Arabia, South Korea, Singapore, China and Kuwait. Under MITI guidelines, a refiner's production quota would be reduced by the amount it imports. Although no quantities were specified in the law—which will remain in effect until 31 March 1996—[redacted]

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[redacted] refiners plan to import between 21,000 and 28,000 b/d of gasoline in first-quarter 1986, which equates to about 3 percent of 1985 gasoline demand. [redacted]

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*Greek-Soviet  
Gas Negotiations*

Greece is expected to contract early in 1986 for 1 to 2 billion cubic meters (bcm) per year of Soviet natural gas, according to Embassy reporting.

[redacted] discussions in Moscow last month failed to resolve differences on price, pipeline construction, and levels of Greek exports to the USSR [redacted]

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[redacted] Prior to its trip to Moscow, the Greek delegation visited Algiers to discuss the feasibility of importing about 1 bcm annually of liquified natural gas. Press reports indicate that the Algerian visit may have been a ploy for the talks in Moscow. The Embassy believes Moscow is pushing to conclude a contract quickly to coordinate the construction of two pipeline spurs designed to deliver Soviet gas to both Greece and Turkey. [redacted]

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*Soviet Yamburg  
Pipeline Construction*

Construction of the Yamburg—Progress—pipeline for export of Soviet gas to Eastern Europe will begin this month, according to a Soviet announcement. Bulgaria, Hungary, Czechoslovakia, East Germany, Poland, and Romania will contribute manpower and equipment in return for 20-22 billion cubic meters of Soviet gas per year beginning in 1989. Prague announced that Czechoslovakia will receive 5 billion cubic meters of gas annually for 20 years in exchange for contributing equipment and 12,000 workers for the construction of 580 kilometers of pipeline, eight compressor stations, and a gas treatment plant in the Urals. The Soviets may plan to use spare capacity in the pipeline eventually to increase gas deliveries to Western Europe. [redacted]

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*Possible Oil Discovery  
in Barents Sea*

The Soviets claim to have found oil and gas during recent exploratory drilling in the Barents Sea, according to Norway's NATO representative. No foreign firms were allowed to participate in the exploration, but the Soviets have not decided whether to allow Western participation in future development and production in the Barents Sea. This is the first official report of an oil discovery in the Barents Sea since they began offshore drilling in 1982. Oil production in the area is unlikely to begin before 1990 even if the Soviets begin a crash development program and obtain full access to Western technology. They are unlikely to develop any new gas deposits offshore before the year 2000 because vast untapped gas reserves are available onshore. [redacted]

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**International Finance**

*Italian Bank Support  
for Baker Initiative*

The Bank of Italy is drafting a statement of support for the debt initiative proposed by US Treasury Secretary Baker [redacted] Meanwhile, the Italian Banking Association has asked the government to relax loan regulations and change its income tax policies in order to facilitate participation by the banks in the initiative; Italian banks are being asked to

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contribute \$260 million to the \$20 billion package. Many members of the association would like some kind of government guarantee for the new commitments, more international oversight of debtor country adjustment policies, and inclusion of more African nations, as well as the CEMA countries. Nonetheless, the Italian banks believe the initiative is a necessary step toward correcting the LDC debt problem. The banking association has asked that new loans extended under the initiative be considered outside current ceilings on foreign lending—a request that is likely to be approved by the Bank of Italy. The banks have also requested that they be allowed to transfer income to reserves against the foreign credits without incurring tax liabilities, as is now allowed with domestic loans. Although Rome has yet to comment on the tax issue, its concern for the LDC debt problem suggests that a favorable response is likely. [REDACTED]

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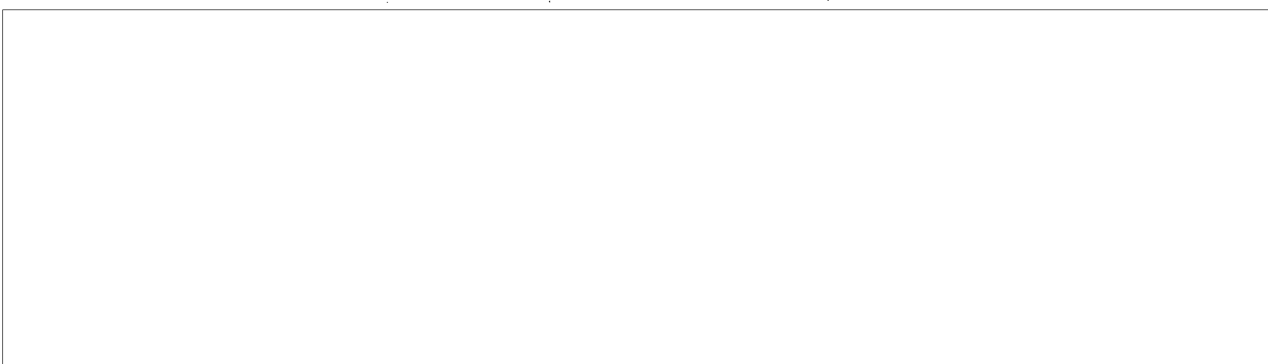
*Threat to Yugoslav  
IMF Program*

The US Embassy says Belgrade is preparing to slash domestic interest rates by one-third in violation of its IMF standby agreement. An alternative stabilization plan drawn up by the central bank would effectively end compliance with the IMF target for interest rates higher than the rate of inflation. Talks with fund officials on this issue are likely to resume in January. A collapse of the IMF accord would seriously harm Belgrade's prospects for a multiyear rescheduling agreement with its Western government creditors. [REDACTED]

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[REDACTED] The government's interest rate policy has been heavily criticized by many Yugoslavs over the past few months for adding to inflation and curbing growth. Some cabinet members favoring positive real interest rates may hope an IMF threat to terminate its agreement will strengthen their hand. [REDACTED]

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**Global and Regional Developments**

*Proposed EC Farm  
Policy Reforms*

The EC Commission presented a set of guidelines on reform of the Common Agricultural Policy to the members' agricultural ministers last month. These include the need for price cuts to reduce oversupply and for improved cooperation among the world's major agricultural exporters to lessen trade frictions. The Commission has also proposed specific measures to reduce

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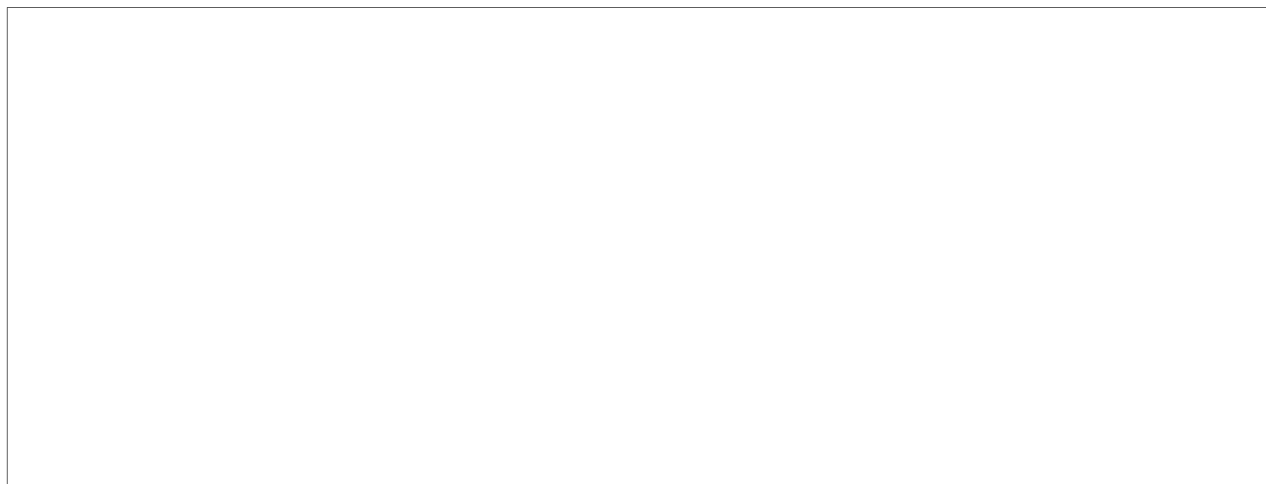
overproduction of cereal, beef, and dairy products, including a tax on cereal production that would be used to finance export subsidies. The modest proposals—aimed at curbing government spending on agriculture—must be approved by EC members. A firm decision is unlikely before the French elections in March. The producer's tax on cereals probably will be adopted in some form, and the EC may decide to push for market-sharing agreements on grain with the United States and other exporters. [ ]

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*LDCs React Favorably  
To Veto of Textile Bill*

LDC reaction to President Reagan's veto of the Jenkins textile and apparel trade bill has been universally favorable. The LDCs still fear, however, that mounting pressure from the textile bill's supporters in the United States will cause Washington to impose tougher restrictions, import quotas, or other measures to curtail textile imports. The textile-exporting LDCs realize that the battle is not over, especially in view of rapidly expanding US apparel imports from non-Multifiber Arrangement countries and see the renegotiation of the MFA next summer as a crucial test for Washington's future textile policy. [ ]

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*Japanese Automakers  
Plan Increased  
Production in Canada*

Earlier this month Toyota and Honda separately announced plans for auto production in Canada in the late 1980s. Toyota will build a plant that will produce 50,000 autos by 1988. Honda has doubled the planned output of a facility currently under construction to 80,000 autos by 1989. Honda expects to start Canadian production in late 1986, manufacturing 30,000 autos in 1987. We believe both intend to ship Canadian-produced autos to the United States,

[ ] Both manufacturers have stated their Canadian production will have high local content—60-percent North American content is necessary to allow unrestricted shipments to the United States under the US-Canada auto pact. [ ]

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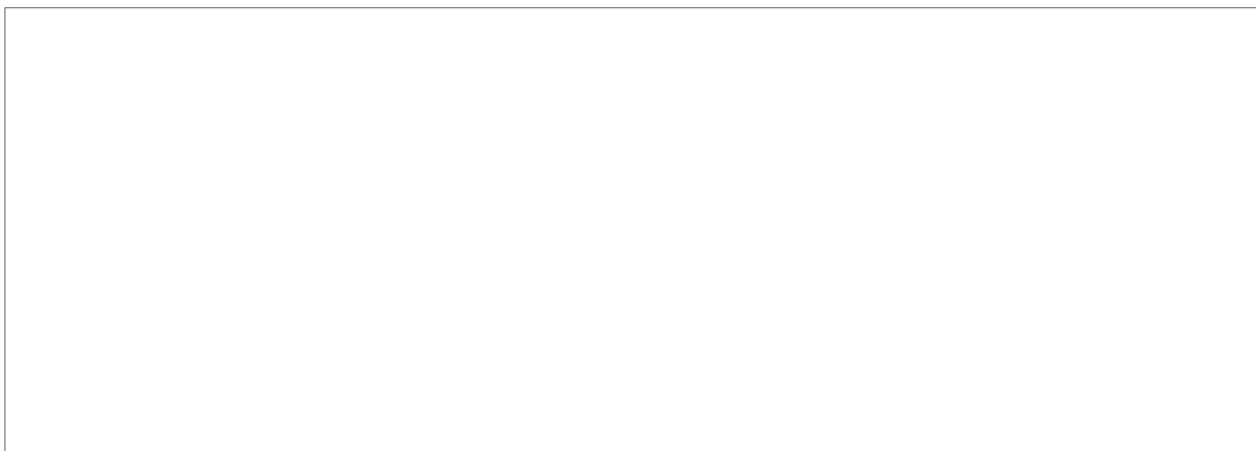
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**Secret*****West Germans Blocking  
US COCOM Proposal***

West Germany is vigorously opposing a US COCOM proposal to embargo certain tunnel- and shaft-boring machines. Two West German companies are the only non-US suppliers of this equipment, whose deep boring capabilities in hard rock make it uniquely suited to the construction of strategic bunkers capable of surviving a nuclear attack. According to the US delegation, it was readily apparent that the West German delegation had high-level instructions to kill, or at least delay, the US proposal. Bonn probably is concerned that such an embargo would set a precedent for embargoing other heavy equipment and impair West German business with the USSR.

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**National Developments*****Developed Countries***

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***Japanese Develop  
Process for Bending  
Ceramics***

According to the Japanese technical press, researchers at the Government Industrial Research Institute in Nagoya have, for the first time, bent and formed ceramics in ways common to metals. The Institute reportedly bent



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pieces of zirconia into rings, choosing this shape because automobile manufacturers potentially could use this process to make piston rings. Japan has made a vigorous effort to develop structural ceramics and associated manufacturing processes to make automobile engines more fuel efficient. The Japanese achievements are a dramatic advance in demonstrating the workability of ceramic materials. Nevertheless, the Japanese are probably far from commercializing the new processes that are slow and require high temperatures, and thus inherently expensive. [ ]

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### ***Less Developed Countries***

#### ***Decline in Argentine Wheat Exports***

Argentina's current wheat crop may fall to less than 9 million metric tons, one-third less than the 13 million-ton crop expected as of early November, because of recent flood damage. Such a drop would leave only 4.5 million tons available for export—20 percent less than outstanding export commitments [ ]

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[ ] Under standard contract terms, the Argentine National Grain Board can cut back deliveries to its customers by 10 percent. Buenos Aires is also trying to deal with the anticipated shortfall by renegotiating contracts with Brazil, China, Iran, and Peru. Argentina's grain agreement with the USSR does not cover wheat, and Soviet officials have already shifted planned December wheat purchases from Argentina to the EC, Australia, and the United States. Lowered grain export earnings will further complicate Buenos Aires' efforts to pay interest on its foreign debt, and probably impede attempts to cut export tax rates to stimulate production in the medium term. [ ]

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#### ***Chile's New Export Rebates***

Santiago has responded to pressures from foreign creditors to earn more foreign exchange by approving legislation to widen its export base. The major incentive, however—a grant to qualifying exporters of 10 percent of the value of their exported merchandise—appears to violate the GATT subsidies code. The present size of the program does not pose a major threat to Chile's trading partners because only \$60 million or 1.6 percent of Chile's total exports qualify; the rebate is limited to goods whose current export value is under \$2.5 million; and the subsidy ends when the total value of the rebates reaches \$7.5 million. Nevertheless, the measure may lead to significant future Chilean penetration of some markets among the 360 product categories covered by the rebates. This could provoke friction with industrialized countries already facing domestic pressures to restrict imports. [ ]

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#### ***Moroccan Food Problems Mount***

Price hikes of 7 to 10 percent on flour, milk and coffee, coupled with regional shortages, are testing consumer patience and frustrating government efforts to meet IMF-suggested budget targets. According to the US Embassy, domestic discontent is likely to worsen this winter as the government attempts to cut subsidy payments to millers by mandating an increase in the production of virtually unsubsidized luxury flour and a decrease in production of heavily subsidized common flour. Luxury flour costs twice as much as common and requires more wheat to produce. Moreover, the government may face a wheat

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supply shortage this winter because of the disruption in US CCC wheat shipments last spring. [REDACTED]

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[REDACTED] the subsidy reductions sharply increase the risk of food price and supply disruptions such as those that sparked bloody riots in January 1984.

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[REDACTED]

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*Tunisian Labor  
Ferment*

The rank and file in Tunisia's powerful labor movement continue to smart over the removal of longtime labor boss Habib Achour by the government in December and ongoing efforts to curtail union prerogatives. Union-government relations reached a crisis in early December over a threatened national strike and stalled wage negotiations. [REDACTED]

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[REDACTED]

[REDACTED] If the government is unable to consolidate control over the unions soon, labor peace may cost Prime Minister Mzali much more than the 5- to 10-percent wage increase asked for by Achour. [REDACTED]

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*Tunisian Education  
Reforms*

Government plans to restrict access to Tunisia's universities have caused student protests and some violence throughout the school system. The decision was driven by the high cost of education—14 percent of Tunisia's strained budget. Nevertheless, Prime Minister Mzali's solution threatens to alienate lower- and middle- class Tunisians who have come to expect free education and view a university degree as a key to upward mobility. Moreover, dislocated students are ripe for exploitation by Islamic fundamentalists or more radical groups. Unrest so far has been concentrated among high school students in areas with a history of street violence, but the return of students to class this month could spark more widespread demonstrations. [REDACTED]

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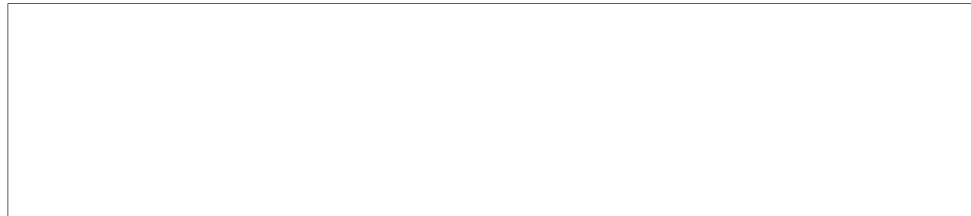
*Partial Devaluation  
of the Syrian Pound*

The Syrian Government recently announced that public and private exporters can now convert foreign currency earned through the export of agricultural and industrial products back into Syrian pounds at the tourist exchange rate of 8.25 pounds to the dollar. Formerly such conversions were at the parallel rate of 5.4 pounds per dollar. This partial devaluation is the latest and most sweeping of a series of moves by Syria's new reform-minded Minister of Economy and Foreign Trade, Muhammad Imadi. With the black-market rate of the pound now around 14 to the dollar, however, the move is viewed as too little and too late and is likely to generate only modest increases in conversions in the legal market. [REDACTED]

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[REDACTED]

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**Communist*****Soviet Winter Grain  
Conditions Favorable***

Despite delays caused by a late grain harvest this fall, the Soviets report farmers have been able to sow about 95 percent of the planned 40 million hectares to winter crops—primarily winter grains. Although the planted area is about the same as last year's, the winter grain area to which intensive technology is being applied has expanded from 6 million to 14 million hectares. Weather data and satellite photography indicate normal to above-normal precipitation during the fall, vigorous growth, and adequate snow cover in most areas. This is the best start in four years for the winter grain crop, which normally accounts for about one-third of the USSR's total grain output.



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***USSR  
"Chemicalization"  
Program Announced***

The Soviet Minister of the Chemical Industry recently announced details of a broad program for the "chemicalization" of the Soviet economy up to the year 2000. Production of plastics and resins is planned to grow at an average annual rate of 6.3 percent; chemical fibers, 4.7 percent; fertilizers, 3.6 percent; caustic soda, 3.2 percent; and household products, 5.7 percent. These data imply an average annual growth rate of output of about 4 percent for the chemical industry as a whole in 1986-2000—similar to that of 1981-85. The program calls for accelerated development of engineering plastics, which can replace metal in machinery, and of substitutes for food products used in chemical manufacturing, such as edible oils now used in paints. Meeting the plan may be realistic for fertilizers and plastics but difficult for fibers in view of recent performance. 

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***Soviet Poll on  
Standard of Living***

A recently released report on a Soviet poll conducted in 1981-82 of citizens' opinions on living standards indicates that almost 75 percent of those polled believed they lived better than they did in the 1976-80 period. Moreover, 95 percent of the adult population considered itself "not badly" provided for materially. The report estimates that 54 percent of all adult citizens felt that life was working out "well," 44 percent believed that things were going only "satisfactorily," and only 2 percent believed that things were going "badly." In contrast, the report said that 5 to 15 percent of all Americans have "a low degree of satisfaction" with their lives and that the share is growing. Official concern over popular sentiment has risen considerably since the late 1970s because of the impact on consumption of the sharp slowdown in economic growth that began in the mid-1970s. The results, however, indicate that a

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sizable minority—probably larger than 25 percent given the presumed reluctance to answer official questions candidly—perceived, as far back as the early 1980s, that their standard of living had stagnated for a prolonged period. The poll—considered by Soviet authorities to be a landmark survey—was probably designed not just to ascertain but to shape public opinion. [ ]

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#### *New CEMA Initiative*

CEMA premiers met last month in Moscow and adopted an ambitious program for science and technology cooperation to the year 2000. Soviet Premier Ryzhkov said that recently established Soviet intersectoral S&T complexes will coordinate Soviet work on CEMA projects in priority areas and will be authorized to contract directly with East European counterparts. To flesh out the program, participants signed a cooperation agreement covering fiber-optics and automated design systems and established the first multilateral science and production association, Interrobot. The new program is the biggest step toward CEMA integration since 1971. The USSR has pushed the program in part to further its own industrial modernization goals. Although all East European countries stand to reap some benefit, the more technically advanced East Germans, Czechoslovaks, and Hungarians may find that the price of their commitment—forgone domestic efforts and loss of competitive advantages within CEMA—may outweigh the gains. The required organizational and planning changes may substantially increase Moscow's control of East European policies. [ ]

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#### *China Looking for Gold*

China's Ministry of Geology and Mineral Resources is making an extensive effort to locate new gold reserves. The Ministry wants to double the present production of 50 tons yearly by the end of the Seventh Five-Year Plan (1986-90). China's official gold stocks were 12.7 million troy ounces in August. One recent discovery in Shandong Province appears to be the largest gold deposit in the country and may increase reserves by as much as one-third. China claims to rank fourth in world gold reserves and sixth in output. Much of China's gold production now comes from small mines operated by individuals and collectives. To boost output at these mines, Beijing has doubled the domestic purchase price of gold to more than \$300 an ounce and set aside \$50 million to lend to miners. [ ]

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#### *Chinese Port Expansion*

Zhanjiang port, China's seventh largest, has completed six new 10,000-ton class berths, increasing the port's cargo handling capacity by nearly 20 percent. The expanded facilities are expected to give the port a greater role in supporting offshore oil exploration activities. A newly installed grain elevator probably will be used mainly for South China's rice exports. The other ports with grain elevators—Dalian, Shanghai, and Huangpu—had been receiving large amounts of imported grains until last year. With bumper corn harvests, those ports now are handling some grain exports, especially Dalian which has shipped corn to Japan and the Soviet Union [ ]

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